Commencement Address
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Financing Higher Education II.

THE DANGERS OF INCOME CONTINGENCY LOANS*

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Today, you have reached a major goal in your quest for formal higher education. For many of you, this will be the end of that formal process as you leave here to assume a new, contributory role in society. Others will continue in the process to seek higher degrees, and indeed may become a part of the educational system itself.

As you enjoy the flush of achievement, it may seem a bit strange to you that I want to address my brief remarks on this occasion to a rather somber subject -- the cost and financing of education. Indeed, you may think me something of a spoilsport for introducing such a serious note into this festive day.

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* This is the second in a series of discussions on the financing of higher education. The first was "Higher Education: Who Benefits? Who Pays?" given as the commencement address at Oakland University, June 5, 1971.

But those who have had the opportunity to obtain a higher education have a special responsibility to sustain and promote higher education in the future. The cost of education is something that you and your parents have lived with for a number of years. Graduation does not necessarily end the concern. For many of you, the joy of graduation is tempered by the knowledge that the next day begins the long and arduous process of repaying the accumulated debt which helped pay for your degree. However, regardless of whether or not you are indebted, as contributing members of society -- as parents and taxpayers -- the developing crisis in financing higher education becomes part of your responsibility.

The crisis is ironic, for the pressures to reduce the public commitment to support higher education come at a time in history when our society and economy have reached a level of complexity which makes a highly-educated citizenry indispensable.

Let us look at some of the factors which contribute to the pressures that affect public support.

-- Campus discontent, which leads many taxpayers and legislators to feel that those whom they are supporting show a singular lack of appreciation.

-- Unemployed college graduates whose presence, despite their degrees, raise questions as to the validity of their education and the planning which produced them for a non-existent job market.

-- Greater demand on tax revenues for other social purposes, which leaves less for higher education.

-- New pressures on the family budget, caused by inflation, higher taxes, and unemployment.

-- Rapidly increasing costs of higher education, resulting from inflation, expansion and the complexities of new curricula.

Of course, this last point -- the increasing costs of higher education -- closes the circle and reinforces the growing reluctance to provide greater public support.

Recent studies show that the costs of a university education have been increasing at an average annual rate of about 15 percent per year.[1/] Even more alarming has been the persistent trend toward shifting a larger and larger share of the costs of an education to the student.

Educational loans and similar repayment plans are a permanent feature of the academic scene and one which is hardly likely to disappear. There is a particular type of loan which is attracting a great deal of attention across the nation which is usually called "income contingency" loans or humorously described as "study now, pay more later."[2/] In my brief remarks today, I would like to share with you my views,as an economist,about some potentially very undesirable consequences of such loans.

1/ Ernest Becker, "The Financing of Higher Education: A review of historical Trends and Projections for 1975-76," Trends in Post Secondary Education, (Department of Health, Education and Welfare, Washington, D. C.: U. S. Government Printing Office, October 1970) p. 99

2/ I realize that one such proposal has been introduced by the Governor of Ohio and must apologize in advance lest I be chastised for poor form at expressing critical remarks of one's host. Let me assure you that my comments are basically directed at the genus "income contingency loan" plans rather than any specific plan and that my essential objection is not with the goal but with the means.

In the past twenty years, there have been drastic changes in the policies which guide the disbursement of scholarships and financial aid to students. There has been a growing recognition that financial barriers have prevented or inhibited a large number of talented and able youths from attaining a higher education. This awareness has resulted in scholarship and financial-aid policies based primarily upon economic need rather than solely upon academic accomplishment. This change in aid policy has significantly expanded the opportunities for economically disadvantaged students to benefit from our colleges and universities, in a fashion unparalleled since the GI Bill after World War II. We have witnessed an important shift in national policy reducing the financial barriers to college or university attendance. More and more high school graduates with proven academic potential and the motivation are now able to attend an institution of higher education regardless of their economic status.

Unfortunately these efforts to remove the financial barriers to attendance at higher educational institutions have coincided with the growing financial stresses being experienced by both private and public colleges and universities.[3/] Consequently, these serious financial difficulties are compounding attempts to eliminate financial obstacles faced by needy but worthy students. Faced with the prospect of ever-tightening financial stringency, many universities and state administrations have urgently sought new remedies for the fiscal ills which beset them.

3/ The Carnegie Commission on Higher Education recently issued a study which revealed that 540 public and private institutions, including a third of all U.S. universities are in serious financial difficulty. An additional 1,000 institutions were said to be headed toward serious financial difficulty in the near future.

Earl Cheit, The New Depression in Higher Education: A Study of Financial Conditions at 41 Colleges and Universities (New York: McGraw Hill, 1971).

Among the various panaceas is a controversial set of proposals which are best described generically as income contingency loan plans.[4/] The basic features of most income contingency loan plans are fairly similar. Under such plans, a student while enrolled at a college or university receives a loan toward the expenses of his education which he promises to repay after completing his study on the basis of some fixed percentage of his annual income.

4/ The three which have received the greatest attention are the Ford Foundation "PAYE" plan, Yale University's "Tuition Postponement" program, and the recently announced proposal for the State of Ohio.

The Yale plan assumes that the total amount lent will be repaid at interest the same as would be true of a conventional loan plan. The rate of interest to be returned on any amount loaned will be determined by the interest which Yale pays in the market when it borrows the funds. The difference from conventional loans is that the repayment obligation is pooled and tied to the level of income of the individual members of a particular pool. All students participating in the plan who graduate in a particular year would make up an independent pool. Participants obligate themselves to repay .4 percent of their gross adjusted income for each $1,000 borrowed, payments to continue until the fund is repaid at interest. The number of yearly payments required will depend upon the total income of the participants in the pool. No payments are expected after 35 years and at current levels of income the repayment would probably be considerably less.

Under the Ohio plan, every student entering a state university would be required to sign an agreement to repay the state subsidy for his education. The Ohio plan includes some subsidy from the state, for it is not expected to receive all of the state subsidy back at compounded interest. Private schools could join the plan, receive funds from the state, and their students would assume the same obligations to repay the state subsidy as if they had attended a public school. The plan is designed to reduce the state's contribution to higher education. The proposal effectively eliminates the distinction between public and private schools, as far as direct educational services are concerned.

For an excellent review of earlier proposals such as the National Student Loan Bank, the Educational Opportunity Bank, and the Carnegie Commission Bank, see Robert W. Hartman, Credit for College, Public Policy for Student Loans (Carnegie Commission) (New York: McGraw-Hill, 1971) esp. Chapter 6.

The logic of these plans is clear; it goes something like this. Students benefit from a college education as shown by higher average lifetime earnings of the college educated. The student should therefore pay for this economic benefit. However, many students lack the resources to finance an expensive education. The solution then is to improve the capital market, that is, loans should be made available so that no student would be barred from college due to an inability to finance it. However, potential students from poor families may not be willing to borrow the amount needed to finance an expensive education. The amount of the loan looks large compared to family income and it is not certain that a college education would produce enough extra income to make it pay. The answer is a loan to be paid back on the basis of a percentage of earnings. This reduces the risk and uncertainty and every youngster who can benefit from an education has the chance to get one. This brings new money to the hard-pressed educational institutions and relieves the reluctant legislatures of the problem of raising taxes to support higher education.

The proposal sounds good. So why would a university president take the time in a commencement address to question it?

I have several serious objections to these schemes -- let me cite two:

1. Divergence Between Public and Private Benefit

First, such plans will accentuate the already alarming pressures against public support for higher education. These plans must be seen as part of an underlying and growing trend toward a greater and greater burden of the costs of education being borne by the student. This trend flies in the face of this nation's longstanding policy of public support of education.

Deciding "who pays" for higher education should be based upon "who benefits." The basic rationale for public support of education lies in the fact that the person receiving an education does not reap all the rewards; society gains as well. In economist's terms, the social benefits exceed the private benefits. Among the social benefits of education are those which enhance the individual's capacities to contribute to the community as a citizen, and those which contribute to increased productivity of the economy.

We thus have in the case of higher education two very distinct situations in which the social benefits exceed the private benefits. First, there is the fact that society gains from an education something more than the individual is able to capture in income. Second, the university contributes to society both in training high level manpower and in generating new knowledge plus public service ventures, but the institution or people in it rarely capture any of the benefits of these activities as a financial reward. Thus, there are substantial social benefits from both sources in excess of private benefits.

The fundamental danger with income contingency loan plans is that they are contributing further to the trend toward students and their families bearing a greater and greater share of the total costs of an education -- a trend premised upon the erroneous assumption that it is the student solely who benefits from the multifaceted activities of a university. Everyone agrees that a student should pay a fair share of the costs of his education, even though disagreements are likely over what constitutues a "fair share."

What is objectionable is the continuing shift from public support toward greater private support -- toward a greater burden being born by the student and his family. Income contingency loan plans in their present form are a strong contributing element to this trend.

Many persons who support experimentation with such loan programs advocate this approach as an additional source of funds, not as a substitute for community support for higher education. However, the political realities must be considered; pressure is growing to reduce public support and responsibility for higher education. There are many who believe it desirable to replace direct public support of institutions of higher education by either student loans or public grants to students -- or both. I am deeply concerned that these socially mischievous beliefs will be reinforced by the promotion of the income contingency loan concept.

Despite pious protestations to the contrary, the income contingency loan idea constitutes a definite shift away from public decisions and responsibility for the support and control of higher education toward a philosophy of private responsibility and private enterprise -- with major consequences. Most important, the shift would transform the goals, values, and conduct of the entire higher educational system. It would change the character of private schools as well as the public ones.[5/] It will have profound effects on investments in higher education.[6/] And it will also have important socio-political implications for equity and justice.

5/ I do not believe the public versus private school issue can or should be avoided in this discussion. I am convinced that private universities are essential to our educational system and that they are highly complementary to public institutions. I am interested in high quality private education as well as high quality public education. But in fairness it should be pointed out that the high quality private universities have never been financed entirely by student fees. Private universities have not been public in the traditional sense, but in a broader sense they have been community supported institutions because their support has come largely through tax-exempt contributions. These exemptions were agreed to by the public and thus the resources which flow to the private universities have been the result of a public decision, even though the choice of a particular institution is private.

6/ The impact of a higher degree of "student consumerism" upon the allocation of educational resources is likely to be extensive. Because the private benefits and the social benefits from education diverge, a student's rational economic decisions will reflect only his calculus not that of society. These and related implications will be examined further on another occasion.

2. Equal Access and Selectivity

One of the most frequently mentioned arguments in favor of income contingency loan plans is their attractiveness in aiding the economically disadvantaged student to secure a college education. Superficially, these proposals would appear to be ideally suited to the needs of low-income youth. But a more careful analysis of these proposals reveals that they are more likely to discourage such youth from attending college.

A basic argument in favor of the income contingency loan approach is that potential students from lower-income families see a conventional debt as a formidable obligation -- and as a result judge the investment in higher education as unreasonable or unattainable. A young man (and his parents) from a family with a \$5,000 per year income would view a \$5,000 debt required to acquire an education as a more significant problem than a young man from a family with a \$35,000 per year income. It is further argued that repayment of a loan based upon actual income earned rather than a straight interest loan would appear less risky and difficult to the lower-income youth. However, an empirical question remains as to whether in fact significantly larger numbers of potential students from low-income families would borrow under such plans than would utilize conventional loans. Even though such a loan might require an annual payment of only two percent of gross adjusted income, the repayment would be stretched over 35 years and might be perceived as a poor investment by a low-income youth.7/

7/ For example, under the Yale plan, a student entering in the Fall, 1971, could defer $800. In subsequent years he could postpone any additional charges to an anticipated total of $5,000. Since the current role of repayment is .4 percent per $1,000 borrowed, a student entering in the Fall, 1971, and graduating in 1976 could incur a maximum charge of 2 percent of his annual income for 35 years. However, keep in mind that such a loan will not cover all costs. Students from very low income families will generally require funds to meet a major share of living expenses as well as to pay tuition. An obligation of this magnitude would certainly discourage many potential students.

Another important issue is the "pooling effect" under which a student borrower joins a particular pool of graduates and whose aggregate earnings and repayment records affect his debt obligation. For example, as I understand the Yale proposal, the .4 percent repayment is based upon the relatively high $35,000 average annual income of Yale graduates. A pool of students with much lower expected incomes would have to carry a higher rate.

Thus, two students with the same incomes over the 35 years after graduation might pay significantly different amounts for the same loans, depending on the average earnings of the group in their pool. However, the variation in payments is limited in the Yale plan by the option to buy out at 150 percent of the loan at compounded interest. Thus, those in the pool who have earnings causing their obligations to exceed this buy-out level would have an incentive to buy out. Even the University would have an incentive to encourage the financially successful participants to buy out of the plan and to contribute the excess to the university rather than using it to reduce the obligations of the remaining members of the pool.

What then would be the effect of a national system in which each college was financed by similar plans, each college with a separate pool? Two students with the same incomes attending different colleges could pay very different rates due to the difference in average income of the participants in the pool. A student attending a teacher's college, for example, could expect to pay a much higher rate of his income than a student attending Yale. This would introduce a new and undesirable incentive in selecting schools. It also emphasizes the tax aspect of the income contingency loan approach and the inequity of the repayment associated with the selectivity of the pool. A multi-institutional pool would, by contrast, have the disadvantage of discouraging participation on a selective basis. It would turn out to be even more inequitable for those forced by need and circumstance into the loan and payment pool.

The most important equity question relates to the possible selectiveness of the participants in any such plan. Those expecting above average earnings (viz., medicine) who had access to conventional loans or other funding would probably not participate. Hence, plan participation would tend to be concentrated among those with lower income. A student from a middle-income or wealthy family who expects to earn a high income during his productive years would prefer either to have his family pay for his education or to secure a traditional loan with interest. Under either arrangement, the total cost of his education would be a smaller fraction of his total expected income than under an income contingency plan. Thus, those students who are likely to be involved in income contingency loan plans are those from low-income and low-middle income families -- exactly those elements in our society who can afford these costs the least. Thus, in any income contingency loan plan, there will be an automatic selectivity which will limit participation largely to the low-income student -- a regressivity directly contrary to stated public policy. Little wonder that there are those who call income contingency loans a plan for "lifelong indenture."

Another important problem to consider in this context is the very low participation in higher education by low-income members of minority groups in the United States. In situations where there is little cultural pressure to seek a higher education and a general aversion to accepting long-term obligations, a 35-year loan, even on an income contingency basis is certain to be perceived as a major barrier to higher education. These young people need much more financial aid than merely tuition costs so they are likely to face correspondingly larger debt obligations.

It is particularly ironic that at the very moment when we are opening access to higher education for the economically disadvantaged segments of our society, we are simultaneously placing a greater cost burden on students. In the present case, we are shifting the burden to those very segments of society which can afford to bear it the least. At the very moment when society is beginning to recognize the greater societal benefits from a dollar spent on the educational improvement of the economically and educationally disadvantaged -- compared with the benefits from a similar dollar spent on welfare -- we chose to increase the financial burden borne by students from such backgrounds who decide to seek higher education. We piously announce that we will provide broader access to higher education while at the same time we prepare to reduce the level of subsidy for this new generation of students.

Let me pause here for a moment and offer a word of caution. Far too frequently the issue of differential impact upon disadvantaged students is seen from a limited ethnic or racial perspective. So much publicity and attention has been given to special programs for Blacks, Chicanos, Puerto Ricans and American Indians that the public often acquires the erroneous impression that the bulk of such funds and financial aid are directed to these groups. The facts of the matter are quite the reverse. For example, in the 1967-68 academic year, the number of Blacks who benefited from Federal financial-aid programs totalled 94,278, while 574,229 whites received such aid.[8/] While a larger percentage of all full-time Black students received such aid (about one-third) compared with whites (roughly 13 percent), the overwhelming total numbers of students who benefited were not the ethnic minorities but whites. Because the eligibility requirements for these programs

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8/ W. Lee Hansen, "An Examination of Barriers to College Attendance," Trends in Post Secondary Education, (Department of Health, Education and Welfare, Washington, D. C.: U. S. Government Printing Office, October 1970) p. 49, Table 21.

are based upon parental income, the majority of the funds go to low-income students, and the vast majority of the needy students in colleges and universities are white, not Black, Brown or Red.

I stress this point of fact because the issues which I have outlined related to income contingency plans are likely to affect <u>all</u> students from low-income families, not merely those from minority groups. While it may be true that proportionately the impact will be greater among the minorities because a larger fraction of them continue to be poor; in absolute numbers, it is the whites who are the largest. Thus, the proposals advanced to facilitate university attendance by the economically disadvantaged of our nation should not be viewed from a parochial ethnic perspective but from a national one.

There are a number of additional criticisms which might be made, such as the forcing of universities into a tax-collector role for which they are ill-suited. The Federal Government is already experiencing sizeable problems over its uncollected and uncollectable student loans. If the Federal Government is having difficulty, what success is a university likely to have?

Finally, we need to be reminded that our adoption of the progressive income tax many years ago already captures much, if not all, of the cost of educational subsidy implicit in the institutional funding approach. Such a tax philosophy recognizes the need for redistributive equity via governmental expenditures in support of education. If this already exists, why introduce such a burden a second time?

Some Alternatives

As is undoubtedly obvious by now, I do not believe the present versions of income contingency loans offer an economically or socially sound basis for meeting the increased costs of higher education in the United States. But the problem remains. What alternatives do we have?[9/] I do not see any simple solutions.

Given our limited understanding of the economics of the system of higher education in the United States, we need careful and comprehensive analysis of the consequences of alternative patterns of financing of higher education. A narrow focus on income contingency plans is not only undesirable but dangerous.

9/ Two excellent recent reviews are Robert W. Hartman, Credit for College, Public Policy for Student Loans (New York: McGraw-Hill, 1971) and Joseph D. Boyd, "An Examination of State Efforts to Remove Financial Barriers to Post-Secondary Education," Trends in Post-Secondary Education, (Department of Health, Education and Welfare, Washington, D.C.: U.S. Government Printing Office, October 1970).

Further, I believe the financial problem will become more acute in the future. Education is essentially a service -- a service which is performed by people who generally have good economic alternatives. The application of technology and industrial processes is relatively more effective in increasing productivity and thus reducing costs in the production of goods as contrasted to services. While I am confident that the productivity of educational activities will be improved, I am equally convinced that changes in the nature and quality of the educational product required and demanded will more than consume any productivity gains.

Because knowledge is cumulative, the product of education is continuously changing also. However, the cost of a year of instruction can be expected to increase substantially relative to the costs of goods and services in general. This is an economic fact of life and must be recognized in planning an economic policy for education. Because I believe both the cost of education and the social need for education will increase, I am reluctant to accept any proposal which might undermine public education in the United States.

Based upon my current understanding of the economics of the United States' system of higher education, I would propose some important modifications in the financing pattern but not a radical departure from the idea that higher education should be financed from a variety of sources. I believe the pluralistic system of higher education is a good one and that the combination of public and private support is needed to support the pluralistic system.

I would argue that a very considerable increase in funding from the Federal tax system would be desirable and economically sound. This is consistent with my belief that a very substantial social benefit accrues from the investment in higher education at both public and private institutions. For a number of reasons most states seem to be unable or unwilling to provide the needed funds. College graduates are highly mobile, perhaps leading to the conclusion that the taxpayers of an individual state get a limited return from investing in higher education. Rather than an unrestricted program of Federal revenue sharing, I would propose the Federal Government assume responsibility to provide foundation levels of funds in some specific program areas.[10/]

10/ The various proposals for institutional support currently being considered by Congress are an important, though modest, step in the right direction.

Conclusion

In summary, I believe the best allocation of resources to education and the best use of resources by the system will result from a policy of public support for higher education. With support for the direct educational expenses in the form of institutional grants, with additional financial aid and work opportunities available, such a policy will help assure that every student capable of benefiting from higher education will have the opportunity and incentive to continue his or her education. Income contingency loan plans may offer temporary help to some individual universities -- though I remain skeptical. Certainly such a plan does not offer a significant advantage over conventional loans, and certainly they are not the best answer to the critical general problem of financing U. S. higher education.

If the greatest number are to be served and served effectively by our higher educational systems and in turn benefit society in the years ahead, we cannot and must not withdraw from this nation's historic public commitment to support public education.

At this particular point in history, any withdrawal might well undermine the future of higher education in this country.